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SUBJECT: Expert report on best practices for financial analysts in the EU

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¶1. (SBU) Summary: In September a group of European experts issued a report to the European Commission with 31 recommendations on best practices for financial analysts. This work coincides with work underway in the US, UK and the International Organization of Securities Commissions (IOSCO). In September IOSCO issued a statement of principles to guide regulators regarding potential conflicts of interest financial analysts may encounter. The Commission has called for comments on the expert report and will issue a Communication of its policy approach next year. Since financial analysts issue products for use globally, they have to adhere to the strictest rules. A European approach that is in line with IOSCO principles may help to avoid potential conflicts with other national laws in the future - assuming IOSCO members implement the principles themselves. End Summary.

Ministers Ask for a Report

¶2. (SBU) In April 2002, against the background of market abuses that have shaken investor confidence, the European Commission and the EU Economics and Finance Ministers, at their informal meeting at Oviedo, Spain, invited the Commission to assess the role of financial analysts and possible measures to improve their participation in the market. In November 2002, the Commission asked a group of experts to research and evaluate current regulatory and market practice issues concerning financial analysis, notably those pertaining to the assessment of securities traded on debt and equity markets, with a view to recommending optimal regulatory and best practice options within an integrated European capital market. The group consisted of 21 European experts, mostly from private banks and investment firms and their associations, but also from national regulators, as well as consultants and one academic.

Report on Financial Analysts

¶3. (SBU) The report of the group, which was released at the beginning of September 2003, is meant to be a first step in a process which should develop over time through "continued and thorough consultation involving national regulators, professional bodies and market practitioners." The report particularly covers conflicts of interest resulting from analyst involvement in new issues and other corporate finance work, best practices for issuers, analysts' remuneration and own account dealing in securities.

¶4. (SBU) The group notes that while its recommendations should respect and reflect the nature, structure and practices of European financial markets, Europe is part of a global marketplace and cannot be treated in isolation. For instance, the recent comprehensive regulatory reforms in the US will have a global impact because the firms they affect are globally active and may thus decide to adhere to US rules in other jurisdictions.

¶5. (SBU) The experts agreed that the European approach to problems perceived in the investment research industry world-wide should be principles-based, emphasizing transparency and self-governance, rather than rules-based. Their recommendations deliberately concentrate on actions, behaviors and outcomes, rather than the legal means of delivery. The recommendations have been framed so that they could be implemented on a pan-European basis - either through EU legislation or by cooperation among national regulators and supervisors, assisted by professional bodies and market practitioners.

¶6. (SBU) The Forum Group produced a list of five core principles which it believes should be applied by those producing and disseminating investment research:

Clarity: research should be fair, clear and not misleading
Competence, conduct and personal integrity: research should be produced by competent analysts with skill, care, diligence and integrity; and it should reflect the opinion of its author(s)
Suitability and market integrity: research should be distributed taking into account the different categories of its intended recipients and the need to maintain market integrity
Conflict avoidance, prevention and management: analysts' firms should have in place systems and controls to identify and avoid, prevent or manage personal and corporate conflicts of interest

¶7. (SBU) Disclosure: conflicts of interest, whether corporate or personal, should be prominently disclosed.

¶8. (SBU) The report makes 31 recommendations which relate to these principles. These focus in particular on conflicts of interest resulting from analyst involvement in securities offerings and other corporate finance work; best practice for companies issuing securities; remuneration of analysts; securities dealing by analysts; qualifications; and the distribution of investment research to the retail market. More generally, the experts recommend that investment research produced and disseminated in the EU should comply with the principles and standards advocated in their report , regardless of the location of the subject companies covered in the research.

¶9. (SBU) With regard to research from third countries, the group argues that it should be permitted for use in the EU if it was produced under equivalent rules. Where the dissemination of research from third countries that is not produced to equivalent standards is permitted, this should be prominently disclosed. Moreover, the experts recommend that the EU should seek acceptance of its standards in other jurisdictions relating to the production and dissemination of research.

¶10. (SBU) The group also notes that some of the issues discussed are already covered by the EU Market Abuse Directive or the Investment Services Directive.

¶11. (SBU) Overall, the principles and recommendations appear to be rather general and self-evident. For instance, "research analysts should adhere to the highest ethical standards." According to a Commission official the expert group did not always agree, so that their report reflects a rather low common denominator.

¶12. (SBU) The Commission announced that in assessing the Group's report and any necessity for follow-up action at the EU-level, it will seek to strike a balance between ensuring investor protection, allowing investors to benefit from an open and competitive market for financial research and investment advice, and avoiding undue restrictions on the services investment banks can offer, thus ensuring that listed companies have access to the corporate finance services they need. The Commission has asked for comments from interested parties by November 30th 2003.

Commission expert View

¶13. (SBU) A Commission expert working on the report explained that the trickiest issue was whether banks could manage the potential conflict between its financial analysts and investment banking department. He also admitted that the report was rather broad and hoped that the comments the Commission will receive will give them "more orientation" on how to address the issue. He personally doubted that new legislation was needed, particularly given that the Market Abuse Directive and Investment Services Directive address some of the potential conflict of interest issues. He thought that next year the Commission would issue a "Communication" that would present its views on how to proceed.

¶14. (SBU) On the provisions regarding financial analysts from third countries, this expert reported that the topic had been subject to very little discussion. The group also did not have a real discussion of the US Securities and Exchange Commission's approved changes to the NASD and NYSE rules to address conflicts of interest raised when research analysts recommend securities in public communications. He thought that investment banks had not reacted to these rules as negatively as auditing firms had reacted to the new US registration requirements.

A View From the Market

¶15. (SBU) We talked to a contact at Deutsche Bank who had been listed as member of the expert group. He told us that he only participated in the very first meeting and would have considered it a "waste of time" to come back. He criticized that most other members of the expert group, even from banks, were not practicing analysts, i.e. often came from other departments and did not know much about the practical side. He felt that his views were not sufficiently taken into account.

¶16. (SBU) Our contact argued that the approach of the group was wrong, as it focused on bank analysts. In his opinion

journalists and tip letters should be regulated as well. He stressed that while analysts only speak with professional investors, the other two groups give their advise to retail investors, are not regulated as banks are, and have a very small reputational risk. Moreover, our contact argued that the issuer's prospectus is the most important source of information in an IPO and that regulation should thus focus on its accuracy. He pointed out that as a consequence of regulation, independent research houses are being opened, which are not regulated and make investment recommendations that could just be as harmful to investors as those of banks. (Note: The expert group recommended that analysts in independent houses should be required to respect the principle of the report.) With regard to EU regulation, the Deutsche Bank analyst stated that banks doing business on a global scale will always adhere to the strictest rules world-wide anyway. It makes no sense to differentiate between markets.

Other Developments

¶17. (SBU) At the beginning of September, the British Financial Services Authority (FSA) announced that it will not enact specific rules for analysts regarding their independence as well as conflicts of interest. Instead it will publish general principles, which will be in line with those formulated by IOSCO as well as with EU policies in the framework of the market abuse directive. FSA chairman Howard Davies stressed that his organization starts from the assumption that it is the obligation of each bank's top management to eliminate obvious conflicts of interest. Thus, the FSA continues to rely on the self-regulation approach it has been following so far.

¶18. (SBU) In May the SEC approved proposed changes of rules by NASD and NYSE to address conflicts of interest that are raised when research analysts recommend securities in public communications. The EU expert group's report and the Market Abuse Directive overlaps with several of these, such as limitations on relationships and communications between investment banking departments and analysts, linking an analysts compensation to specific investment banking transactions, compensation by firms for investment banking services, restrictions on trading by analysts and disclosures of financial interests. However, the SEC approved rules, generally, tend to be more prescriptive and not general principles.

¶19. (SBU) At the end of September, the International Organization of Securities Commissions (IOSCO) issued a Statement of Principles to guide regulators and other in addressing the conflicts of interest that analysts may face. The principles, inspired by the SEC approved rules cited above, stipulate that mechanisms should exist so that analysts' work is not prejudiced by their or their employers' financial or business relationship interests, and that reporting lines should be structured to eliminate or severely limit actual or potential conflicts of interest. Moreover, firms should establish written internal procedures to identify, eliminate, manage or disclose actual or potential conflicts of interest. There should be no undue influence of issuers, institutional investors or other outside parties on analysts. Disclosure of actual or potential conflicts of interest should be complete, timely, clear, concise, specific and prominent. Analysts should be held to high integrity standards. Investor education should play an important role in managing analyst conflicts of interest.

¶20. (SBU) These principles are combined with a set of "core measures" that are considered necessary to properly address potential conflicts of interests. These "core measures" contain clear prohibitions, e.g. of analysts or their employers trading securities ahead of publishing research on the issuer, of analysts reporting to the investment banking function or participating in investment banking sales pitches. The German Financial Supervisory Authority (BaFin) announced that it is in favor of making these principles binding in Germany. The British FSA stated that it will largely adopt the IOSCO principles. Experts believe that they will also considerably influence the EU directives on market abuse and investment services.

Comment

¶21. (SBU) The issue of investment banks and analysts has been an issue raised in Germany while the "Neuer Market" was melting down. Efforts by the Economics Ministry to forge a voluntary code of conduct could not secure sufficient agreement among all interested parties. Investors' groups, however, still see a need.

¶22. (SBU) EU legislation is already covering part of these issues, such as the Market Abuse Directive and its implementing measures on the fair presentation of investment recommendations and the disclosure of conflicts of interest. However, even in those rules developed by the Committee of European Securities Regulators, the approach is more towards disclosure than prescriptive rules. As the Deutsche Bank analyst observed, global investment banks have to comply

with the strictest rules. If those are in the US, then, in his view, the US rules rule.

¶23. (SBU) Since the EU has yet to propose any standards on financial analysts it would stand to reason that whatever they propose should be in line with those adopted by IOSCO. The fact that IOSCO standards reflect US standards is partially a function that securities market regulators have similar views on the topic rather than bowing to US influence. Having similar rules in the US and EU could help avoid potential problems and conflicts in the future.

¶24. (U) This cable was coordinated with Embassy Berlin and USEU.

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